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UNCLAS SECTION 01 OF 07 FRANKFURT 009824

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E.O. 12958: N/A
TAGS: ECON EFIN EUN
SUBJECT: The EU Stability and Growth Pact: Dead, On Ice, It Lives; Form Over Substance?

T-IA-F-03-0062

REF: (A) Frankfurt 08852; (B) Berlin 4399; (C) Paris 8585; (D) Paris 8620


(1) (SBU) Summary: The failure of EU Finance Ministers to find a compromise on November 25 acceptable to all on the treatment of Germany and France under the Stability and Growth Pact (SGP) sent another negative signal on the viability of rules to coordinate fiscal policy in a monetary union without political union. The European Central Bank (ECB)'s statement that Econfin's conclusions "carry serious dangers" is a reflection of their concern that one of the institutional underpinnings of the European Monetary Union has been weakened.

(2) (SBU) A close reading of Ecofin's conclusions suggests that the disagreements were more over process than substance. Fundamentally, the issue was who is responsible for fiscal policy coordination, member states or the European Commission? By rejecting the Commission's recommendations, the Council sent a clear message: it's the member states. Failure to find common ground between all member states and the Commission on such an important, high profile issue could be a set back for the cooperative spirit necessary for SGP rules to be effective.

(3) (SBU) On substance, the qualified majority of Ministers agreed that Germany and France should correct their excessive deficits by 2005 rather than 2004, given the weak economic recovery. The Commission had come to the same conclusion. However, the Commission had recommended that France and Germany (a) be found not to have complied with Ecofin's earlier recommendations (reftels); and (b) be notched up on the SGP's disciplinary rack, to just under the sanctions rung. In so doing, the next time these countries were found not in compliance with the Ecofin's recommendations, they could face sanctions. In this way, the Commission sought to bring along the hard-line, smaller countries that were disgruntled with giving the next year for Germany and France to get their budgets in shape. This procedure proved to be the undoing of any compromise.

(4) (SBU) German Finance Minister Eichel took the lead in opposing the Commission's proposal, not wanting to appear to be "punished" (a German Finance Ministry characterization) for doing the "right thing," particularly at a time when he is facing tough domestic budget battles with the opposition and his own party. France was comfortable riding in Germany's draft, calculatedly showing signs of "flexibility" that, in the end, would be meaningless given Germany's tough stance.

(5) (SBU) While seemingly orthodox on substance but off the consensus line on process, different portrayals of the SGP have been rendered: it is variously dead, on ice, or lives. The consequences of failure to reach unanimous agreement, however, could be serious -- not immediately for financial markets, but for the future. Other instances of this inability of member states or the Commission to find common ground in the economic world have cropped up under the Italian Presidency (Investment Services Directive, Takeover Directive) and could well spill over into other areas such as the drafting of the Constitutional Treaty for Europe. While one or two disputes might not send a signal to financial markets, the inability to shape a more workable Europe could. End Summary


## The Setting and Conclusions of November 25: Just the Facts

(6) (SBU) Earlier this year Ecofin had declared that France and Germany have deficits that exceed the 3% of GDP reference value in the EU Treaty and would be handled under

the SGP's "excessive deficit procedures." On October 8 the EC had recommended, in accordance with Article 104(8) of the Treaty, that France had taken no effective action to implement Ecofin's June recommendations to correct its excessive deficit. On October 21 the Commission further recommended that France take further measures to reduce its deficit and that it submit implementation reports every six months over the next two years so the Commission and Council could assess progress. The recommendation was under Article 104(9), the last step before moving to possible sanctions if France were to fail to comply with the new recommendations. Finally, the Commission gave France an extra year, to 2005, to correct its deficit.

(7) (SBU) The Commission's autumn forecast showed that Germany also would fail to reduce its deficit below the 3% of GDP reference value in 2004. On November 18 the Commission drafted similar recommendations for Germany under Articles 104(8) and 104(9).

(8) (SBU) At their November 25 session there was no qualified majority of the Ecofin to accept the EC's recommendations on France and Germany (reftels and USEU septel). Denmark, Spain, Belgium, Sweden, Austria, the Netherlands, Finland and Greece voted for the Commission's recommendation that both countries had taken no effective action to correct their deficits. The same countries voted for the Commission's recommendations under 104(9), except Denmark and Sweden who, because they have not adopted the euro, cannot vote on decisions under Article 104(9).

(9) (SBU) A qualified majority was mustered for an alternative conclusion, described below. Backing the alternative approach on France was Germany, Italy, Greece, Belgium, Portugal, Luxembourg and Ireland. The same group, but substituting France for Germany (since the country subject to the procedures cannot vote on its own case), voted for similar conclusions on Germany.

(10) (SBU) The Commission recorded its position in Ecofin's report of its meeting by noting that Ecofin's rejection of the Commission's recommendation was without any explanation, as required in the SGP, and by stating that Ecofin's earlier recommendation - which was a "decision" -- is still in force (that calls for deficits to be under 3% in 2004). The Commission declared that it regretted that the "spirit and rules" of the SGP were not followed and reserved "the right to examine the implications of the Council conclusions and decide on possible subsequent actions."

Ecofin's Alternative: Broad Agreement with the Commission on Substance
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(11) (SBU) On substance, Ecofin's conclusions were broadly similar to the Commission's recommendations. These call for (a) an end to excessive deficits "as rapidly as possible and at the latest 2005;" (b) structural reforms recommended in the EU's Broad Economic Policy Guidelines to be reflected in implementing measures to reduce the deficits; and (c) an acceleration of the reduction in the cyclically adjusted deficits should the recovery be stronger than currently expected. The Commission wanted any higher-than-projected revenues to be allocated to deficit reduction, while Ecofin agreed to do so only if growth were higher than expected.

(12) (SBU) Slight differences in the speed of structural deficit adjustment in 2004 appear between the two texts. Ecofin called for 0.6 percentage point reduction in Germany compared with the Commission's 0.8. For France Ecofin asked for 0.8 percentage point reduction, rather than 1.0 sought by the Commission.

Econfin's Alternative: Major Difference on Procedures
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(13) (SBU) The fundamental difference between Ecofin's and the Commission`s approach was on process. Ecofin did not act on the basis of Treaty Article 104(9) as proposed by the Commission. Under this Article, if a member state "persists in failing to put into practice the recommendations of the Council may decide to give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction.. And can request reports in accordance with a specific timetable to "examine the adjustment efforts." Instead, Ecofin just issued more recommendations, an iteration of their earlier action under Article 104(7). The difference is that failing to comply with recommendations under 104(9) would mean that the next stop would be sanctions.

(14) (SBU) In addition, Ecofin called for "biannual notifications" on progress in fulfilling their commitments with the Commission and Council to give "due attention to prevailing economic conditions and the structural reforms

being implemented." The Commission had recommended four "implementation reports" over the next two years to assess progress.

Germany: Takes the Lead - France in its Draft
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(15) (SBU) Germany would not accept being subjected to a recommendation under Article 104(9), full stop. According to a Commission official, this was the fundamental stumbling block. The German delegation could agree to many formulations, but none that included Article 104(9). One formulation sought to give Germany assurances that a recommendation under 104(9) would not lead automatically to sanctions if Germany were doing its best to reduce the deficit. No dice.

(16) (SBU) The German position, according to several German Finance Ministry officials, was driven by their view that they had lived up to Ecofin's recommendations issued to Germany in February. The Commission had confirmed that when they assessed Germany's policies in May (ref a and b). Deterioration in Germany's 2003 structural budget position, as highlighted in the Commission's new autumn forecast, was a reflection of other changed circumstances, not a change in Germany's budget policies. Specifically, German Finance Ministry experts point that that revisions of the statistical series, lower inflation (meaning lower revenues than budgeted), and the Commission's assumption of lower potential output all conspired to increase Germany's structural deficit.

(17) (SBU) The Commission's recommendation to reduce the structural deficit by an additional 0.2 percentage points to 0.8 was unappreciated. The government is still uncertain of getting its budget and reform package adopted that would cause an estimated 0.6 percentage point reduction already programmed into the Commission's calculations. According to a German Finance Ministry, the Commission said it was trying to help Finance Minister Eichel in his tough budget debates. With the final shape of the package in flux, the Commission thought now was a good time to up the ante. From the Ministry's viewpoint, the Commission's meddling came at a particularly bad time in the domestic political debate. Despite having taken tough, unpopular measures in 2003, the Commission's move to Article 104(8) and 104(9) was being construed as "punishment," in the words of one German official, for "doing the right thing." It was asserting that Germany had taken no measures and was being put on formal legal notice of defaulting on its obligations. "This is ridiculous; the Minister will not accept it."

Buddy System: Two Sink or Two Swim?
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(18) (SBU) German Finance Ministry officials were also irritated that their case was being put together with that of the French. In their view, France had been disdainful of SGP procedures. German Finance Ministry officials explained that they had privately been working with French finance officials, coaxing them to take additional budget consolidation measures. That seemed to be working, in their view. France had announced a 0.1 percentage point additional cut to their structural deficit for 2004. The SGP was exerting pressure and "working" in their assessment.

(19) (SBU) The Commission's case on Germany was issued on November 18 and put on the November 25 Ecofin agenda together with the French case, the discussion of which had been postponed from the November 4 Ecofin meeting. Why not postpone discussion on the German case, pleading the need for more time, thus de-linking the substantive debate on the two?

(20) (SBU) One German Finance Ministry official said "there is a certain dynamic" between Germany and France that made the linkage inevitable. Another was resigned that a fight was inevitable, so postponement "won't help." The Commission logic, according to an official close to the process, was the assumption that Germany would not vote on the merits of the French case, rather would be driven by politics. Despite their private displeasure with the French, the Germans would support them in a vote.

(21) (SBU) Also, the French had insisted on equal treatment with Germany. The Commission's recommendations on Germany were virtually identical to those for France, a point the Commission recorded in its press release. An ECB official pointed out that while the German rhetoric had been positive toward the SGP, the numbers looked about the same. Germany had not reduced its structural deficit as it had pledged - although not because of the central government's policies.

(22) (SBU) Twinning benefited France. According to a Commission official, Germany did most of the talking. France demonstrated some flexibility, but maybe, mused this

official, because they knew it would not be taken up given Germany's immoveable position on Article 104(9).

(23) (SBU) French Finance Minister Mer could never have accepted a recommendation under Article 104(9) directed at France alone. While Germany might technically have asked for a final delay to December 12 in Ecofin consideration of its respect for the Commission's recommendations, France had no more room for maneuver. Mer went into the Euro Group meeting having signaled to the press that the GOF would bring flexibility to the table, but all indications are that he had no mandate to accept the Commission's recommendation of a 1%-of-GDP cut in the 2004 structural deficit. Thus he could stand shoulder to shoulder with Eichel (or perhaps, back to back) in an absolute rejection of a recommendation uner Article 104(9).

(24) (SBU) Despite Italian Finance Minister Tremonti's claims just a few weeks that SGP targets should be upheld, his reversal to support the Germans and French is not surprising. Tremonti has often expressed his concern that the SGP does not encourage economic growth - and in country with the lowest growth rates in the EU, this concern resonates particularly well. The Italian Government also realizes that it could be well be standing in German shoes next year; even under the most optimistic economic predictions, Italy in 2004 will likely be hovering around the three percent deficit ratio. Self-interest rather than esprit de corps with the French and Germans prompted Tremonti's "change of heart."

The Commission: Rejected Again -- Principles and Practicalities
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(25) (SBU) The Commission wrapped its position in principle. In explaining the decision to the European Parliament in Strasbourg on November 18, Commissioner Solbes declared that "The College stood firmly by the principle that we are a Community of law and that the Treaty and the Stability and Growth Pact have to be applied together." While Germany had taken budget consolidation measures in 2003, it is in "non-compliance" with the Council recommendation to end its excessive deficit situation in 2004. Therefore the Commission has an obligation to inform the Council of this fact and "recommend further steps to be taken according to Article 104(9)."

(26) (SBU) The Germans argued that the Commission took a "mechanistic" approach. First, the Commission could not assert that Germany had taken "on effective action," since, as noted above, the Commission had signed off Germany's package as recently as May. Second, even if the actions were inadequate, there is nothing in the Pact or the Treaty to suggest a country should be immediately treated under 104(9), in their view. A German Finance Ministry official reports that the Council's legal services shared this view - at odds with the Commission's legal services. Ecofin's approach, in the view of theis official, was to "update" the earlier recommendations in light of changed circumstances since Germany has complied with the recommendations but the deficit failed to respond.

(27) (SBU) By using Article 104(9), the last stop before landing on the possibility of sanctions, the Commission sought to increase pressure on Germany and France, thereby seeking to appease the hard-line countries who were disgruntled that the Commission had given both countries the extra year to correct their excessive deficits. According to a Commission official, the smaller countries would have accepted the Commission's compromise. Excluding action under 104(9) meant no compromise. And so it was.

(28) (SBU) A neater legal solution would have been for the Commission to see which way the wind was blowing then, with the appropriate concessions to save its face, proposed revised recommendations based on the approach favored by the qualified majority. The Commission, according to this German official, knew it did not have the votes on France as early as the first week in November. Not heeding the warning signs, the Commission barreled along, putting the German case on the table as well. The Commission, in this official's view, was heading for failure. In the negotiations the Commission demonstrated flexibility on substance, but not on process. In the end, the Commission's decision to stick to their guns was not Commissioner Solbes decision to make, according to this official, but left to the President of the Commission.

ECB: "Serious Dangers"
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(29) (SBU) The ECB had been concerned about the debate and had weighed in on the side of the Commission's compromise. In its November Monthly Bulletin the ECB reported that the "Governing Council takes the view that the proposals of the

Commission push the room for interpretation of the rules and procedures to the limit." A senior ECB official repeated this statement when asked the ECB's view on the Commission compromise.

(30) (SBU) In his first major policy speech on November 20, ECB President Trichet made an impassioned plea: " I very profoundly wish an hope that all partners concerned will, in the coming days, live up to their responsibilities: The Commission, the Council, the governments concerned, so that we can not only preserve but reinforce the overall credibility of the euro area, and therefore growth." Trichet and Vice President Papademous participated in Ecofin's all night discussions on November 24 that ran until 4:30 am.

(31) (SBU) Following Ecofin's conclusions, the ECB's extraordinary press release declared that the Governing Council "deeply regrets these developments and shares the views of the Commission on the Ecofin Council conclusions. The Conclusions adopted by the Ecofin Council carry serious dangers. The failure to go along with the rules and procedures foreseen in the Stability and Growth Pact risks undermining the credibility of the institutional framework and the confidence in sound public finances of Member States across the euro area." This is "serious," in the words of an ECB official.

## A Word From the Market

(32) (SBU) As confirmed by an ECB official, the decision had no effect on the market. However, one currency strategist said if this disagreement were to lead to a break-down of the Inter Governmental Conference, such a break down would send negative signals to investors about the euro. Ecofin's decisions could have implications for the IGC's negotiations on a Constitutional Treaty for Europe, potentially making agreement more difficult rather than less.

## Two Observations: Deeper Meaning of the Pact

(33) (SBU) As a comment, we limit ourselves to two observations, one on the operation of the SGP, the other on the potential deeper implications.

(34) (SBU) With respect to the operation of the SGP, it has been variously described as "dead," (Financial Times),"on ice" (Dutch Prime Minister) and "living" (German Finance Minister Eichel). We discount the FT's view since they are generally negative on the SGP in principle (although they have softened of late - agreeing on the need for rules to coordinate fiscal policy in the monetary union). The FT's ability to generate so many stories on a "dead" agreement suggests the SGP has more lives than the proverbial cats' nine.

(35) (SBU) The Dutch have a point, but one enshrined in the SGP. If countries fulfill Ecofin's recommendations, then the excessive deficit procedures are considered to be in abeyance. Ecofin made that explicit in its conclusions.

(36) (SBU) Eichel too has a point. The SGP continues to exert peer pressure and is taken seriously, very seriously in Germany. Over the November 28-29 weekend German Finance Ministry officials conveyed their views to the press that the SGP included the necessary flexibility to accommodate the current economic situation. Perhaps this could explain why Eichel reacted so strongly. Entrenched in a political battle not only with the opposition but also his own party for his budget stewardship. After using the SGP to help justify his own predeliction for subsidy cuts and keeping deficits as low as possible, to be seen as "punished" by the SGP procedures would be a political cut of the deepest sort. Groused one Finance Ministry official - "the SGP means nothing to the French population - in Germany it does." The irony of Germany's position in the SGP continues to compound: the principal author, one of the first test cases, now running interference for the French. Eichel is playing a high stakes game domestically that has washed over to the EU level - increasing the stakes considerably.

(37) (SBU) The second observation is on the deeper meaning of Ecofin's decision. One reason to be concerned with the outcome is the failure to find a compromise that was acceptable to all. The SGP is more than rules. It is almost a state of mind, of the individual members reflected the broad good of the whole - being communautaire. Coordination of fiscal policy in a single monetary union is a cooperative exercise, depending upon compliance with rules - not enforcement.

(38) (SBU) A key to moving forward is to recapture that cooperative spirit. Pursuing the issue in courts is a questionable tactic to foster cooperation. Moreover, it

implies that the SGP is a precise legal covenant. The Commission's portrayal of its position as one of principle and legal correctness is also questionable. Arguing that because its forecast estimates that Germany will have a deficit over 3% in 2004 requires the Commission to use 104(9) because Germany "persists" in failing to adopt Council recommendations might be tough in front of a judge.

(39) (SBU) The Commission itself chose to exercise the SGP's flexibility that excessive deficits "should" be corrected in the year after they are identified by pushing the date out one more year. In fact, the Treaty, the basis for the Pact, gives no date certain for the deficits to be corrected. Both Solbes and Tremonti are correct when saying the Commission's and Ecofin's positions were, at once, "political" - both seeking to find a view acceptable to all, if not a qualified majority of member states, and "law based" using the SGP rules and Ecofin voting procedures. The SGP rules provide a framework, not a chemical formula.

(40) (SBU) Existentialist believe that "we are our choices." Having made their choice, all Ecofin members and the Commission should come together. Visible, meaningful results in Germany and France budget programs would be the most important and necessary step toward this end. Going to court is a question of finding who has power. Do member states coordinate fiscal policy or the Commission? That should be settled in the IGC.

(41) (SBU) Italy's EU presidency has seen two other decisions in which important interests were overridden by votes: the Investment Services Directive (UK, Ireland, Finland, Sweden opposition overridden) and the Takeover Directive (the Commission's position overridden). As to whether this is any indication of the current spirit of cooperation on larger issues, like the ICG, only time will tell.

(42) (U) This cable coordinated with USEU and Embassies Berlin, Paris and Rome.

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